

2. What are the tax results of these alternative characterizations of the transfer of [REDACTED] both as to this transaction and as to [REDACTED]'s subsequent sale of [REDACTED] to a third party?

This advice does not address the issue of the valuation of [REDACTED] and we note that the Service has not obtained a formal valuation of [REDACTED]

We conclude that the facts gathered to date support the determination that the transfer was a distribution from [REDACTED] to its shareholder [REDACTED] not a sale. This conclusion is based on the fact that there is no documentation to support the purported sale or an associated redemption, the taxpayer initially characterized the transaction as a dividend distribution on its Form 5471, Schedule O for [REDACTED] for the [REDACTED] tax year and the taxpayer continued with this characterization in its initial responses to inquiries during the audit.

Alternatively, even if the taxpayer were able to provide sufficient factual support for the purported redemption, without any documentation of a sale with an actual exchange of consideration, this would be considered a redemption for property in kind. As such, it would be treated as a distribution of property subject to the provisions of I.R.C. § 301.

Pursuant to I.R.C. § 301, the tax consequences of a distribution of property to a shareholder are the same whether the distribution is characterized as a redemption of stock or a distribution of property. The results are:

- a. The amount of the distribution is the fair market value of [REDACTED] [I.R.C. § 301(b)(1)];
- b. As [REDACTED] did not have any available E&P, [REDACTED] must reduce its basis in the remaining stock it holds in [REDACTED] [I.R.C. § 301(c)(2)];
- c. As [REDACTED] did not have any E&P to reduce, the I.R.C. § 312(a)(3) requirement that [REDACTED] reduce E&P due to the distribution is not applicable. However, [REDACTED] cannot claim a loss on the distribution of [REDACTED] [I.R.C. § 311(a)];
- d. [REDACTED] takes [REDACTED] the distributed property, with a basis equal to its fair market value [I.R.C. § 301(d)]; and
- e. [REDACTED]'s reduced basis in [REDACTED] reduces [REDACTED]'s capital loss on its subsequent sale of [REDACTED] [I.R.C. § 1001].

FACTS

This transaction involves subsidiaries of the former [REDACTED] subsequent to its acquisition by [REDACTED] in [REDACTED]. [REDACTED] was a wholly owned subsidiary of [REDACTED]

[redacted] which in turn was a wholly owned subsidiary of [redacted]
[redacted], a domestic holding company of [redacted]
[redacted]¹

For ease of reference, the entity structure is as follows:



All of the relevant underlying activity occurred within a [redacted] month period at the end of [redacted]. On [redacted] the Board of Directors for [redacted] issued a resolution authorizing the sale of [redacted] to [redacted]² [redacted] months later, on [redacted] [redacted] transferred [redacted] and its subsidiary entities to [redacted].

By resolution dated [redacted] the [redacted] Board of Directors authorized (i) the transfer of [redacted] to [redacted] for consideration of \$ [redacted] and (ii) the redemption of [redacted]'s shares of [redacted] in an amount sufficient to reduce [redacted]'s capital to \$ [redacted]³. There are no documents to show that [redacted] ever received the consideration stated in this Board resolution.

On [redacted] [redacted] sold its stock in [redacted] to a third party in a separate transaction. Schedule D of [redacted]'s Consolidated Income Tax Return for [redacted] reported a capital loss of \$ [redacted] on the sale of [redacted].

1. [redacted]'s Initial Characterization As a Dividend

With regard to the transfer of [redacted] [redacted] stated in its Form 5471 for [redacted] (Schedule O) for the year ending [redacted] that:

[redacted]

¹ The supporting documentation uses different abbreviations for the various entities. For clarity, this memorandum will refer to the entities as [redacted], [redacted] and [redacted].

² Issue No. [redacted]

³ Issue No. [redacted]

[REDACTED]

(Form 5471 for [REDACTED] Schedule O, Section E - Attachment #2; emphasis added).⁴ [REDACTED] filed Form 5471 for [REDACTED] as part of [REDACTED]'s consolidated return in [REDACTED]

During the current audit, Information Document Request (IDR) No. [REDACTED] was submitted to [REDACTED] regarding adjustments to [REDACTED]'s basis in [REDACTED] to reflect the transfer of [REDACTED]. In [REDACTED] [REDACTED] provided the following handwritten response:

See computation of [REDACTED]'s [REDACTED] basis at w/p [REDACTED] showing basis of \$ [REDACTED]. As discussed, we will use the cost basis to adjust [REDACTED]'s basis in [REDACTED]. [REDACTED]'s basis in [REDACTED] should be reduced by \$ [REDACTED].⁵

2. [REDACTED]'s Subsequent Characterization As A Sale And Redemption

In [REDACTED] [REDACTED] sought to retract its [REDACTED] response to IDR No. [REDACTED] and to characterize the transaction as a sale of [REDACTED] for its net asset value of \$ [REDACTED].⁶ According to [REDACTED] a sale would not result in any adjustment to [REDACTED]'s basis in [REDACTED].⁷

To support this new position, [REDACTED] pointed to the Board resolutions of [REDACTED] and [REDACTED] as well as to an internal [REDACTED] memorandum, dated [REDACTED]. The [REDACTED] memorandum stated that [REDACTED] was to be sold to [REDACTED] for its net tangible asset value on a date to be determined.⁸ Despite these resolutions and the memorandum, [REDACTED] has not been able to find a sales contract regarding the transaction and does not believe that any exists.⁹

⁴ Issue No. [REDACTED]

⁵ Issue No. [REDACTED]

⁶ As stated previously, this advice does not discuss the issue of the valuation of [REDACTED] and the Service has not obtained a formal valuation of the entity.

⁷ Issue No. [REDACTED]

⁸ Issue No. [REDACTED]

⁹ Issue No. [REDACTED]

There also do not appear to be any accounting entries to document the purported sale. According to [redacted]'s internal accounting memorandum of [redacted] [redacted] did not pay [redacted] for [redacted] apparently based on the position that "[t]he impact on [redacted]'s transparent as [redacted] would have redeemed an additional \$ [redacted] in capital to [redacted]"¹⁰ [redacted] did redeem about [redacted] of its stock held by [redacted] but this seems to have been unrelated to any payment for the sale of [redacted]¹¹

Law and Discussion

A. CHARACTERIZATION OF TRANSACTION

This transaction may be characterized as any one of the following transactions:¹²

1. A distribution of the stock of [redacted] to [redacted] the sole shareholder of [redacted] for no consideration; or
2. A redemption of a portion of the [redacted] stock held by [redacted] the sole shareholder, with the redemption paying for the stock in [redacted] or
3. A redemption of a portion of the [redacted] stock held by [redacted] paid for with cash -- immediately followed by a second transaction in which [redacted] returned the cash to [redacted] to purchase [redacted].

1. Option #1: Distribution Of Property To A Shareholder For No Consideration

Based on the information we have, only option #1 is supported by the facts. There is simply no evidence to show that [redacted] paid any consideration for [redacted]. There is no sales contract,¹³ no transfer of funds and no transfer of stock associated with the "sale" of [redacted]. While the board

¹⁰ Issue No. [redacted]

¹¹ Issue No. [redacted]

¹² Please note that none of these alternatives characterizes the distribution as a dividend. Section 316(a) defines "dividend" as a distribution out of earnings and profits, which [redacted] did not have.

¹³ The lack of a sales contract cannot be dismissed as an "unnecessary formality" between related parties. See e.g., the contract regarding the sale of [redacted] to [redacted] by [redacted] on [redacted] [attached as [redacted]]. While this sale occurred prior to [redacted]'s acquisition of [redacted] it demonstrates that sales contracts between related entities are not unknown or unusual.

resolutions and internal accounting memorandums indicate that at the time the transaction was being completed, [REDACTED] may have wanted to structure it as a sale for consideration, no actions were taken to follow up on this intention.

Moreover, it appears that [REDACTED] abandoned any intention it may have had of structuring this transaction as a sale for consideration. In filing its Form 5471 for [REDACTED] [REDACTED] unequivocally states this transaction is a "distribution" to a shareholder and follows the I.R.C. § 301 ordering rules in characterizing the distribution as a tax-free return of capital due to the distributing corporation's lack of E&P.

The statement on the Form 5471 is particularly relevant as it was made approximately [REDACTED] months after the transaction was complete. [REDACTED] months is close enough to the date of the transaction for it to be "fresh," but a sufficient distance to allow adequate consideration of the desired characterization. [REDACTED] had clearly considered a sale/redemption structure, so the only conclusion is that it decided to abandon this structure.

[REDACTED]'s initial response to the IDR in [REDACTED] also supports the view that [REDACTED] abandoned any intention it may have had of characterizing the transaction as a sale and instead decided to structure the arrangement as a distribution of property.

Finally, there is no documentation to show that [REDACTED] received any consideration from [REDACTED] in the purported sale, either in cash or stock. While the [REDACTED] Board resolution states a purchase price of over \$ [REDACTED], there is no documentation that [REDACTED] received any amount of consideration in any form. On the contrary, [REDACTED]'s internal accounting document of [REDACTED] plainly states that [REDACTED] did not pay [REDACTED] for [REDACTED]. This memorandum also disposes of the contention that [REDACTED] received consideration by way of a redemption of [REDACTED]'s holdings in [REDACTED]'s stock. The statement that '[REDACTED] would have redeemed an additional \$ [REDACTED] in capital to [REDACTED]' can only mean that the action was not undertaken at that time and there is no evidence of a subsequent redemption.

In discussing the transaction as a sale and redemption, the [REDACTED] memorandum contains a puzzling statement that the "impact on [REDACTED] is transparent." The only interpretation is that the author believed that a swap of [REDACTED] for redeemed [REDACTED] stock of the same value would have no other effect and thus it was not necessary to do the paperwork to show the sale and the redemption. If this was the conclusion, it is not correct. This statement fails to acknowledge the basis adjustments that must be made when stock is redeemed. (See discussion below re: basis adjustments on redemption).

The tax consequences of Option #1, as a distribution of property to a shareholder, are governed by I.R.C. § 301(c). [I.R.C. § 301(a)] [See section B below for discussion of the tax consequences]

2. Option #2: Distribution Of Property As Redemption

Option #2 would be viable if it can be shown that the redemption actually took place. (Given the significant redemption of ██████'s stock in ██████ this is possible even though ██████ has not yet provided such documentation). However, without any documentation as to a sale with an actual exchange of consideration, the most likely characterization would be a redemption of stock for property in kind.

Unless a redemption falls within the exceptions set forth in I.R.C. § 302(b) for a significant reduction in the redeemed shareholder's equity interest in the corporation, a stock redemption will be treated as I.R.C. § 301 distribution. [I.R.C. § 302(d)] Here, ██████ cannot fit within any of the I.R.C. § 302(b) tests as it retained its ██████% ownership of ██████ after the "redemption."

Thus, whether this is a distribution of property to a shareholder [Option #1] or a redemption of stock by property in kind [Option #2], I.R.C. § 301 applies the same tax consequences to the transaction. [See section B below for discussion of these consequences]

3. Option #3: Two Separate Transactions -- Redemption Followed By Sale

The final option is the new position put forth by ██████ during the audit that despite the lack of any supporting documentation, this was really two different, but related transactions. In the first transaction, ██████ redeemed stock held by ██████ for cash. Then, ██████ immediately returned this cash to ██████ in order to purchase ██████¹⁴

As discussed above, the major problem with this position is the lack of any documentation for either the purported sale or purported redemption. ██████'s failure to follow the necessary forms and supply the necessary paperwork cannot be overlooked as the structuring of the transaction was entirely in its hands.

This lack of documentation and follow through, coupled with ██████'s original position that failed to mention any such sale or redemption, creates a fatal defect in this argument. The odd thing about ██████'s position is that it is arguing the step transaction doctrine in reverse. Instead of taking two separate transactions and arguing that the form should be disregarded and merged into a single transaction, ██████'s position is that in looking at this single transaction (i.e., sending ██████ to ██████ for either no consideration [Option #1] or for redeemed stock [Option #2]), we should disregard the form (the lack of paperwork) and consider this to be two separate transactions.

While we believe there is very little merit to the position outlined in Option #3 given the facts developed to date, we discuss the tax consequences in section B below in the event ██████ provides the relevant documentation in the future.

¹⁴ This must be argued as two separate transactions to distinguish it from Option #2. If it were a single transaction, then it should be considered a redemption for property in kind.

B. TAX CONSEQUENCES

1. Option #1 and 2: Distribution of Property

As discussed above, the tax consequences under Options #1 and 2 are the same as both are subject to the provisions of I.R.C. § 301. Accordingly, whether [redacted] simply distributed [redacted] to [redacted] for no consideration - or - whether [redacted] redeemed some of its stock by distributing [redacted] to [redacted] the tax results are:

- a. The amount of the distribution is the fair market value of [redacted] [I.R.C. § 301(b)(1)];
- b. As [redacted] did not have any available E&P, [redacted] must reduce its basis in the remaining stock it holds in [redacted] [I.R.C. § 301(c)(2)];
- c. As [redacted] did not have any E&P to reduce, the I.R.C. § 312(a)(3) requirement that [redacted] reduce E&P due to the distribution. However, [redacted] cannot claim a loss on the distribution of [redacted] [I.R.C. § 311(a)];
- d. [redacted] takes [redacted] the distributed property, at its fair market value [I.R.C. § 301(d)]; and
- e. [redacted]'s reduced basis in [redacted] reduces [redacted]'s capital loss on its subsequent sale of [redacted] [I.R.C. § 1001].

2. Option #3: Redemption and Sale

To work logically, the redemption would come first to get the "purchase money" to [redacted] then [redacted] would have returned that money to [redacted] when buying [redacted]

i. Redemption

[redacted] pays \$ [redacted] to [redacted] in return for some of [redacted]'s stock held by [redacted]. As discussed above, the redemption is treated as an I.R.C. § 301 distribution as [redacted] retained its [redacted]% interest in [redacted] after the purported redemption.

- a. [redacted]'s basis in its redeemed stock is transferred to the remaining stock it holds [1.302-2(c)];

- b. [REDACTED]'s basis in the remaining stock is reduced by the amount of the distribution [I.R.C. § 301(c)(2)]; and
- c. [REDACTED] has no E&P to reduce as required by I.R.C. § 312(a)(3), but has a \$ [REDACTED] debit to cash.

ii. Sale

[REDACTED] pays the \$ [REDACTED] it received back to [REDACTED] in order to buy [REDACTED]

- a. [REDACTED] gets [REDACTED] with basis equal to its cost [I.R.C. § 1012];
- b. [REDACTED] credits back the \$ [REDACTED] to cash (and takes [REDACTED] off its asset list); and
- c. I.R.C. § 311(a) does not prevent recognition of loss on a sale, but the loss on the sale of [REDACTED] to a member of the same control group must be deferred until [REDACTED] is transferred outside the control group [I.R.C. § 267(f)].

As a result, when [REDACTED] is then sold to the third party, the following tax results occur:

- 1. [REDACTED]'s capital loss on its subsequent sale of [REDACTED] must be reduced to reflect [REDACTED]'s reduced basis in [REDACTED] [I.R.C. § 1001]; and
- 2. [REDACTED] cannot recognize the loss on the sale of [REDACTED] as [REDACTED] is still within the control group. Instead, under the regulations in effect at the time of this transaction, [REDACTED] is allowed to increase its basis in [REDACTED] up to the amount of [REDACTED]'s deferred loss [Treas. Reg. §§ 1.267(f)-1T(c)(6) & (7); Treas. Reg. § 1.267(f)-2T(d)].¹⁵

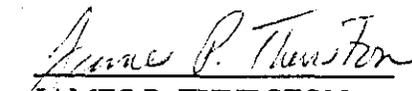
There is no real difference in the outcome under any of the three options as of the time of these transactions. The only difference would be the adjustment to the gain or loss on the sale of [REDACTED] to a third party (if that ever occurred) in order to recognize the loss [REDACTED] incurred on the sale of [REDACTED] to [REDACTED]. [REDACTED]'s loss would never be recognized under Options #1 or #2 due to the prohibition in I.R.C. § 311(a).

¹⁵ These regulations are applicable as they were in effect at the time of this transactions in [REDACTED]. Please note that permanent regulations are now in effect for transactions which take place after July 1995 and these new regulations contain very different provisions.

CONCLUSION

We conclude that the substance of the transaction was a distribution of property in kind from a corporation to its sole shareholder. As such, the shareholder's basis in the corporation must be reduced, which further reduces the capital loss realized on the shareholder's subsequent sale of the corporation to a third party.

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Attachments:

NPA; Issue Number [REDACTED]